# No. 16,330

# United States Court of Appeals

## For the Ninth Circuit

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CHARLES E. HOPPE, Trustee of the Estate of Los Gatos Lumber Products, Inc., a California corporation, Bankrupt,

*Appellant,*

vs.

EMMET L. RITTENHOUSE,

*Appellee.*

## APPELLANT'S CLOSING BRIEF.

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### SUMMARY OF APPELLANT'S POSITION.

Appellant's position is completely set forth in his opening brief, and will be more fully referred to hereafter in connection with his reply to specific points advanced by Appellee. The major premise of Appellant's position is basically that the chattel mortgage which is the basis for Appellee's secured claim, is preferential within the meaning of Sections 60 a and b of the Bankruptcy Act (11 U.S.C.A., Sec. 96 a and b) in that Appellee's assignor not only had reasonable cause to believe that the bankrupt was insolvent at the time of the execution of the chattel mortgage, but that he actually knew that the bankrupt was then and there insolvent.

## ARGUMENT.

Appellee's assignor testified that he believed that the bankrupt's assets exceeded its liabilities at the time of the execution of the chattel mortgage (T.R. pp. 38-39) notwithstanding the facts that (1) he was fully aware of the fact that the bankrupt's statement of July 31, 1956 (Trustee's Exhibit No. 1, T.R. p. 56), clearly showed a deficit of some $66,000.00 in assets as compared with liabilities; (2) that Appellee's assignor had advanced money to the bankrupt to assist it to stay in business until it was refinanced (T.R. p. 34); (3) that it could not remain in business without the refinancing (T.R. p. 40); and (4) that he was attempting to collect the bankrupt's accounts receivable. (T.R. p. 40.)

We further call to the Court's attention that at the time the execution of the chattel mortgage was discussed, the bankrupt pointed out that such a mortgage might jeopardize the obtaining of the loan from the Small Business Administration (T.R. pp. 47, 71), and that the obtaining of the financing was necessary for the bankrupt to continue in business. (T.R. pp. 40, 53.) Appellee, in his brief on pages 3, 4, 6 and 7, sets forth his basic position which is that the bankrupt was not insolvent at the time of the execution of the chattel mortgage, basing this assumption upon the alleged fact that the notes payable of $173,813.12 representing the indebtedness of the bankrupt to the Morton family was to be treated as "equity stock" rather than a liability of the bankrupt. This is based upon the fact, as testified to, that the Morton family

would surrender their notes and take equity stock in lieu thereof, and that this was discussed with Appellee's assignor. (T.R. pp. 68-69, 74-75.) While such assurances probably were made by Morton, we submit that same were subject to specific conditions precedent before the notes would or could be treated as stock. We will concede, for purposes of argument only, that insofar as Morton's mother is concerned, perhaps her contribution was intended to be capital evidenced by stock and not as a loan (Claimant's Exhibit No. 2, T.R. pp. 61-62, 70-71), but this involves only $10,000.00 and does not change Appellant's position or the fact that the balance of $163,000.00 was, prior to the execution of the chattel mortgage, at the time thereof, and at all times thereafter, considered as and constitutes a liability of the corporation, because of failure to meet the conditions precedent to these notes being changed to stock.

Reference is made by Appellee in his brief at pages 4 and 7 to the fact that Morton made similar assurances to other potential investors (T.R. pp. 67-68) and that such a notation was placed upon the balance sheet. (Trustee's Exhibit No. 1, T.R. pp. 67-68.) The testimony of Mr. Morton (T.R. p. 67) shows that these "prior assurances" and the pencil notation on the balance sheet were made in August of 1956 prior to the creation of the situation leading up to the chattel mortgage and which conversations and dealings were not made in the presence of Appellee's assignor, and that, even at that remote date, it was Morton's inten-

tion to convert the notes to stock *only when the financing was obtained.*

Testimony of Carl Morton:

> "At that time I was back in Colorado, talking to people and trying to get a loan for Los Gatos Lumber—I don't know the names of the individuals I talked to—and I was working with the balance sheet at that time to show that *when* stock was taken in lieu of notes payable to officers that the firm's balance sheet assumed a much better light and picture; *if the notes payable to officers were turned over into stock,* were replaced with stock, that the firm would be in much better shape then, and I was talking to two men who might loan money to the corporation—we had agreed to do this—and *the pencil notations were merely my working on that basis as to what would turn out.*" (Italics ours.) (T.R. pp. 67-68.)

The actual fact, we believe, is clearly shown to be that the notes payable by the bankrupt to the Morton family were to be treated as equity stock *when and only when* the conditions precedent were met, to-wit, when the additional financing was obtained by the corporation or when the corporation was sold by Morton. Morton testified to this:

> "A. If we had gone ahead and accomplished what we had agreed to then I presume we would just take the position of stock owners.
>
> Q. And in the event you didn't obtain money on a Small Business Administration loan or from some other source, then what would your status be with reference to being a creditor, or having an obligation (due you), as a stock owner?

A. As a note holder, or stock holder?

Q. Yes.

A. It would stay the same I presume." (T.R. p. 60.)

* * *

"Q. To clarify my mind, to make sure I understand it correctly, Mr. Morton, *the question of the changing of the status of you and your family as far as the notes were concerned, or to change it to stock, was conditional upon the financing—obtaining of the financing?*

A. *Right.*

Q. As a matter of fact, if I remember your letter of the 10th—which is attached to Exhibit No. 4, says—the portion of the application of the Small Business Administration—that is exactly what it says—puts as a condition, 'that said Los Gatos Lumber Products, Inc., obtains from Small Business Administration $150,000.00 within 90 days from date hereof within the lifetime of Carl Morton.' That application had been made prior to the time these advances were made in October, November and December; is that right?

Mr. Rittenhouse. Portions, I believe, of the advances were made after December the third, and portions prior to December 3rd.

A. Yes.

Q. Your letter of intent bears the jurat 'Sworn and subscribed to before me this 10th day of September, 1956'?

A. Yes.

Q. *And Mr. Gammill was fully aware of this application?*

A. *Yes.*" (Italics ours.) (T.R. pp. 72-73.)

In this connection see also testimony of Carl Morton (T.R. p. 58).

Testimony of Paul Gammill, Jr.:

"Q. You worked on the Small Business Administration with Mr. Morton, didn't you?

A. Yes, sir.

Q. And were fully aware of the contents of the application?

A. Yes, I am—I mean——

Q. You were at the time it was presented, weren't you, Mr. Gammill, you were familiar with the transaction?

A. I was familiar with the transaction, yes. I don't remember the content.

Q. But you had seen it at the time?

A. Right, sir." (T.R. p. 76.)

In Appellee's brief on page 7, it is urged that there is uncontradicted testimony that the Morton family agreed to treat their notes as stock, *if others would lend the bankrupt funds.* With this we are in hearty agreement, and the record will clearly bear out the fact that no such loans were obtained either from the persons in Colorado, from the Small Business Administration, or from any other source. Appellee's assignor Gammill and Morton both were fully conversant with the bankrupt's situation and with its attempts to obtain loans, and were also completely familiar with the letter of intent which is part of the application for loan to the Small Business Administration (Claimant's Exhibit No. 4, T.R. p. 70), which clearly shows the conditions precedent, to-wit, that all

of the Morton family agreed to convert notes to stock *if* that loan were to be granted.

At this point we allude to the chameleon-like position of Mr. Morton, shared by Appellee's assignor, in that when it serves a purpose, i.e., to obtain financing to enable the bankrupt to continue in business or for the purpose of selling the business, Mr. Morton states that the notes are stock; but when the petition in bankruptcy is filed, Mr. Morton lists these notes payable as such under the unsecured creditors (Summary of Debts and Assets, T.R. pp. 6-7), and the Morton family files claims in the bankruptcy proceeding based upon the notes (T.R. p. 51), but when it comes to this litigation, these notes are to be considered as stock and thus not a liability of the corporation. The peculiarity of this position is further evidenced by the fact that, for the purpose of financing and selling, a new balance sheet (Trustee's Exhibit No. 2) was made in January, 1957 (T.R. p. 56) *subsequent* to all of the conversations leading up to the execution of the chattel mortgage, and *subsequent* to the filing of the petition in bankruptcy herein (T.R. pp. 3-6), and which balance sheet *still shows* the Morton family indebtedness as *"notes payable"*.

We must, at this point, make reference to the statement on page 8 of Appellant's opening brief referred to in Appellee's brief on page 6, to the effect that had the notes been changed to stock "the financial statement would not have been changed at all except that the corporation indebtedness would be to the stock-

holders rather than the note holders." This statement we freely admit to be incorrect. It was inadvertently included in Appellant's opening brief. We know that the crux of this matter, as stated by the referee (T.R. p. 68) is that if the indebtedness to the Morton family was considered as notes payable, the corporation was insolvent, and Appellee's assignor knew it; whereas, if the notes payable were to be considered as stock, the converse would be true, that is, the corporation would be solvent, and Appellee would be entitled to his security.

In his brief, page 8, Appellee urges that the decision of this Court in *Costello v. Fazio*, 256 F. 2d 903 does not apply "since there was no conflict in the evidence." We agree that there was no conflict *in the evidence.* The only conflict, as will appear from the foregoing, as well as from our discussion (Appellant's Opening Brief, pp. 9-11), is a conflict in the "factual conclusions" drawn from the evidence by the referee. This is exactly the situation to which the *Costello* decision, supra, refers. It is apparent from the testimony of Appellee's witnesses that the agreement to convert the "notes payable" to the Morton family into stock was subject to the happening of the conditions precedent above mentioned. The documentary evidence also indicates (without conflict) that no such conversion actually took place. Hence referee's findings numbered 4 and 6 (T.R. pp. 15-16) are nothing more than "factual conclusions" which are "clearly erroneous" and as such subject to this Court's draw-

ing therefrom "the proper conclusion", which, we submit, cannot be other than that the notes payable continued to exist as liabilities up to the date of the bankruptcy.

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**CONCLUSION.**

In view of the facts and law hereinabove set forth, it is Appellant's contention that the chattel mortgage given by the bankrupt to Appellee's assignor was and is a preference, voidable under the provisions of Sections 60 a and b of the Bankruptcy Act, and that the order here complained of should be, by this Court, reversed, and remanded with instructions to the District Court to make and enter an order that the proof of claim of Appellee be allowed herein only as a general, unsecured claim.

Dated, Burlingame, California,
September 29, 1959.

Respectfully submitted,
SHAPRO & ROTHSCHILD,
By ARTHUR P. SHAPRO,
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Nos. 16331, 16332, 16333

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

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REVELL, INC., etc.,

*Appellants,*

*vs.*

ROBERT A. RIDDELL, District Director of Internal Revenue, and United States of America,

*Appellees.*

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## SUPPLEMENT TO APPELLANTS' BRIEFS.

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## SUPPLEMENT TO APPELLANTS' BRIEFS.

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This supplement to appellants' briefs is for the purpose of adding additional authorities to support the points already made.

### 1.

### Supplement to Part II, Pages 9-10, of Appellants' Opening Brief.

The following unbroken line of authorities is added for the proposition that, subject only to such review as the law provides, an administrative determination is a final decision, and that it is a final choice of any differing possibilities:

*Appeal of Hoskins Manufacturing Co.,* 259 N. W. 334, 336;

*Western Hospital Assn. v. Industrial Accident Board,* 6 P. 2d 845, 848;

*Tracy v. MacIntyre,* 84 P. 2d 526, 528;

*Hanlon v. Rollins, et al.,* 190 N. E. 606, 609;

*New National Coal Co. v. Industrial Commission,* 26 N. E. 2d 510, 512;

*State v. Wright,* 194 S. W. 35, 37;

*Smith v. Board of Education of Walton Co.,* 164 S. E. 41, 43;

*Wood v. Dept. of Public Safety,* 311 S. W. 2d 274, 276;

*Kamo Electric Co-Operative v. Earnest, et al.,* 277 S. W. 2d 876, 879;

*Cramer v. Smith,* 168 S. W. 2d 1039, 1041;

*In re Talbot's Will,* 9 N. Y. S. 2d 806, 812;

*Gooch Milling & Elevator Co. v. Commissioner,* (C. C. A. 8), 133 F. 2d 131, 137;

*State of California v. United States,* 119 Fed. Supp. 174, 177;

*Parish & Bingham Corp. v. United States,* 44 F. 2d 993, 997;

*State v. Bode,* 113 S. W. 2d 805, 808;

*Eastman Kodak Co. v. Richards,* 204 N. Y. Supp. 246, 249;

*Norwood Hospital v. Howton,* 26 So. 2d 427, 432;

*Swift v. Smith,* 201 P. 2d 609, 614;

*Bradner v. Vasquez,* 227 P. 2d 559, 561;

*People v. Escobar,* 264 P. 2d 571, 573.

These cases thus add the support of historic principle, confirmed again and again, to *Terminal Wine Co. v. Commissioner,* 1 B. T. A. 697, cited in appellants' opening

brief. In that case the Tax Court, at p. 701, applied the principle in relation to its jurisdiction as follows:

> "The *determination* from which a taxpayer may appeal is one which fixes the amount of *deficiency* in tax. It is the final decision by which the controversy as to the deficiency is settled and terminated, and by which a final conclusion is reached relative thereto and the extent and measure of the deficiency defined." (Italics in original.)

## 2.

## Supplement to Part III, Pages 10-11, of Appellants' Opening Brief.

It has now been held expressly by the Tax Court that it has no jurisdiction to make an election between contradictory positions urged by the Commissioner. *Prisep v. Commissioner,* 18 T. C. M. 274, 284-285. This conforms to the decision in *Hulburd v. Commissioner,* 296 U. S. 300, 306, 56 S. Ct. 197, 200. In that case the Supreme Court stated:

> "The duty to inquire and determine was imposed by the statute upon him [the Commissioner] and not upon an agency of government established for the purpose of revising his decision [referring to the Tax Court]."

By the same token the Tax Court has no jurisdiction to make an election between contradictory notices of deficiency. That this is clear is especially shown by the paradox which results if the taxpayer goes into the Tax Court on two or more contradictory notices and presents no evidence. What would the Tax Court do? Very obviously such notices give the Tax Court no jurisdiction.

3.

**Supplement to Part V, Pages 12-13, of Appellants' Opening Brief and the Related, Final Paragraph of Appellants' Reply Brief.**

It has been held that in transferee cases the procedure by notice of deficiency, continued under I. R. C. 1954 by. Section 6213(a), made applicable to transferee liability by Section 6901(a), is an additional, statutory procedure, that the procedure by the government by bill in equity to impress assets with a trust, under the trust fund theory, was not affected. *Phillips-Jones Corp. v. Parmley,* 302 U. S. 233, 237, 58 S. Ct. 197, 199; *Payne v. United States* (C. A. 8), 247 F. 2d 481, 484, cert. den., 355 U. S. 923, 78 S. Ct. 367. The proceeding here, however, is not such a procedure by the government by bill in equity.

Section 7421(b), by its express terms, is only applicable to a procedure by the government pursuant to the provisions of Chapter 71, and that chapter, in Section 6901(a) as noted above, applies the statutory procedure by notice of deficiency under Section 6213(a). It follows that Section 7421(b) has no application unless there is a valid notice of deficiency.

4.

**Supplement to the Statement Regarding "Protective" Practice in Appellants' Reply Brief, Page 4, Paragraph Beginning in Line 9.**

The following cases may be added to those cited for the proposition that practice does not sanctify error:

*Biddle v. Commissioner,* 302 U. S. 573, 582, 58 S. Ct. 379;

*Helvering v. Sabine Transportation Co., Inc.,* 318 U. S. 306, 311-312, 63 S. Ct. 569;

*Russell Manufacturing Co. v. United States Court of Claims,* 59-2 U. S. T. C. ¶ 9582, at p. 73446.

These cases show that even when a practice of the Commissioner is embodied in a formal regulation, the practice cannot be upheld where it is erroneous.

Respectfully submitted,

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